

DRAFT



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

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| Date Introduced: | 12/04/06 | Bill No: | SB 24 |
| Tax: | Cigarette and Tobacco Products | Author: | Torlakson |
| Related Bills: | | | |

BILL SUMMARY

This bill would impose an additional excise tax on cigarettes of nine and one-half cents (\$0.095) per cigarette, or \$1.90 per package of 20, and impose an equivalent compensating floor stock tax.¹ The revenue from the tax increase would be deposited into the General Fund and would be used, upon appropriation, for health related purposes.

ANALYSIS

Current Law

The current excise tax on cigarettes is 87 cents per package of 20 (43 ½ mills per cigarette). The different components of the cigarette taxes and the disposition of the revenues are as follows:

- 10 cents per pack (5 mills per cigarette) is allocated to the General Fund (Sections 30101 and 30462 of the Revenue and Taxation Code);
- 2 cents per pack (1 mil per cigarette) is allocated to the Breast Cancer Fund (Sections 30101 and 30461.6);
- 25 cents per pack (12 ½ mills per cigarette) is allocated to the Cigarette and Tobacco Products Surtax Fund (Sections 30122 and 30123); and
- 50 cents per pack (25 mills per cigarette) is allocated to the California Children and Families Trust Fund (Sections 30131.2 and 30131.3).

For other tobacco products (which are defined in Section 30121 and 30131.1 to include cigars, smoking tobacco, chewing tobacco, snuff, and other products containing at least 50 percent tobacco), Section 30123 (Proposition 99) imposes a tax on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 (Proposition 10) imposes an additional tax on tobacco products based on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the 50-cent per pack tax on cigarettes also imposed by Section 30131.2. The tobacco products tax rate is determined annually by the Board and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2006-07 is 46.76 percent.

¹ A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

The other tobacco products surtax imposed under Section 30123 (Proposition 99) is deposited into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the other tobacco products tax triggered by a cigarette tax increase), while the surtax imposed under Section 30131.2 (Proposition 10) is deposited into the California Children and Families Trust Fund.

Proposed Law

Among other things, this bill would add Article 4 (commencing with Section 30133) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of \$1.90 per package of 20 cigarettes (and, as discussed in Comment 2 below, indirectly increase the tax on other tobacco products). The additional tax would be imposed beginning January 1, 2008.

The bill would also impose a compensating floor stock tax on the January 1, 2008, cigarette inventory of a dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a licensed distributor.

The proceeds from the cigarette tax increase, less refunds, and administrative and collection costs, would be deposited into the General Fund, which would be used, upon appropriation, for health related purposes, as determined by the Legislature.

The bill would become effective on January 1, 2008.

Background

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, passed on the November 1998 ballot, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

A number of cigarette tax increase proposals have been considered in recent years, but not enacted, including the following:

| Bill | Year | Author | Proposed Tax Increase |
|----------------|------|---------------------------------------|--|
| Proposition 86 | 2006 | Coalition for a Healthy California | \$2.60 per package of 20, and an equivalent cigarette and other tobacco products floor stock tax. |
| SB 564 | 2006 | Torlakson | \$1.00 per package of 20, and an equivalent compensating floor stock tax. |
| SB 689 | 2003 | Ortiz | \$0.01 per package of 20, and an equivalent compensating floor stock tax. |
| AB 1416 | 2003 | Vargas | \$1.50 per package of 20, and an equivalent compensating floor stock tax. |
| AB 35 | 2003 | Vargas | \$1.50 per package of 20, and an equivalent compensating floor stock tax. |
| SB 1890 | 2002 | Ortiz | \$0.65 per package of 20, an additional excise tax on tobacco products equivalent to the additional cigarette tax, and an equivalent compensating floor stock tax. |
| SB 1849 | 2002 | Committee on Budget and Fiscal Review | \$2.13 per package of 20, and an equivalent compensating floor stock tax. |
| AB 433 | 2002 | Committee on Budget | \$0.63 per package of 20, and imposed an equivalent compensating floor stock tax. |
| AB 428 | 2002 | Committee on Budget | \$0.50 per package of 20, and an equivalent compensating floor stock tax. |

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author and is intended to provide committed funding, in part, for health-related purposes including smoking cessation programs.

2. **Other tobacco products.** This measure does not contain a direct tax increase on other tobacco products. However, the \$1.90 cigarette tax increase would indirectly increase the other tobacco products tax rate July 1, 2008, as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the other tobacco products tax rate, which is required to be determined annually by the Board, must be equivalent to the combined rate of all taxes imposed on cigarettes. As such, a tax increase on other tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.

It should be noted that the proceeds from the resulting tobacco products tax increase would not be deposited into the General Fund. Under existing law, the proceeds from an indirect increase in the other tobacco products tax as a result of Proposition 99 are required to be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99).

3. **Floor stock tax provisions.** Proposed Section 30135 contains language to impose a floor stock tax on the January 1, 2008, cigarette inventory of a dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a licensed distributor. A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate. Generally, a floor stock tax is imposed to equalize the excise tax paid by cigarette dealers (retailers), wholesalers, or distributors on their inventory and those cigarettes and other tobacco products purchased after the effective date of a tax increase.

Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes purchased before the increase, but sold after, can be raised and attributed to the rate increase. These additional funds would represent a windfall profit rather than excise taxes paid to the state. A floor stock tax mitigates this windfall profit.

While the Board would incur additional costs associated with administering the floor stock tax, these costs would be offset by the proceeds from the tax.

4. **Cigarette and tobacco product tax evasion.** Tax evasion is one of the major areas that can reduce state revenues generated from cigarettes and other tobacco products taxes.

During the mid-1990's, the Board's cigarette tax evasion estimates changed little since there was little change to cigarette prices and excise taxes during that time. However, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices (excluding taxes): Proposition 10 and the Tobacco Master Settlement Agreement between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, coincided with an increase in the average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It is estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled the dollar amount of cigarette tax evasion in California.

Since the 1998 experience, many new measures have been implemented to reduce cigarette and other tobacco products tax evasion. These include the Cigarette and

Tobacco Products Licensing Act, an encrypted cigarette tax stamp, and various Internet restrictions (such as agreements with UPS, DHL, and FedEx under which those companies have agreed to stop transporting cigarettes directly to individual consumers nationwide and credit card companies adopting policies to prohibit the use of credit cards for the illegal sale of cigarettes over the Internet).

This measure would increase the cigarette tax substantially, which would result in an increase in the retail price, to the extent that the tax increase is passed along to consumers. Based on previous experience related to Proposition 10 and the tobacco settlement, along with research of experiences in other states, Board staff believes the proposed cigarette tax increase and resulting increase in the other tobacco products tax could result in both a decrease in actual consumption and an increase in cigarette and other tobacco products tax evasion. The exact magnitude of these responses is uncertain since the proposed excise tax increases are significantly greater than previously experienced.

The Board staff is currently in the process of updating the cigarette and other tobacco products tax evasion estimate using data gathered after implementation of the Cigarette and Tobacco Products Licensing Act, as recommended in the Bureau of State Audits report titled "[Board of Equalization: Its Implementation of the Cigarette and Tobacco Products Licensing Act of 2003 Has Helped Stem the Decline in Cigarette Tax Revenues, but It Should Update Its Estimate of Cigarette Tax Evasion](#)." It is anticipated that the updated evasion estimate will be completed by June 29, 2007.

5. **Suggested technical amendments.** This measure would impose an additional excise tax upon every distributor of cigarettes at the rate of nine and one-half cents (\$0.095) for each cigarette that is distributed. For purposes of consistency with existing law, the amount of the proposed additional tax should be referred to in "mills" rather than "cents." For example, nine and one-half cents is nine and one-half mills.

In addition, this bill should be amended to add conforming and necessary code section references added to the Cigarette and Tobacco Products Tax Law in order for the Board to properly administer the surtax in a manner consistent with the other excise taxes imposed on cigarettes and tobacco products. For example, Sections 30104 and 30108, which both reference the cigarette and tobacco tax imposed by Sections 30101, 30123, and 30131.2, would need to be amended to also reference the proposed additional tax in Section 30133.

And lastly, proposed Section 30135(c)(4) should be deleted since stamps bearing the designation "1" are not available.

Board staff is willing to work with the author's office in drafting appropriate amendments.

6. **Administrative start-up cost funding for the Board.** The additional excise tax on cigarettes would begin on January 1, 2008, which is in the middle of the state's fiscal year. In order to properly administer a floor stock tax, notify cigarette distributors, wholesalers and retailers of the additional tax, develop computer programs, reporting forms, and hire appropriate staff, an appropriation is required to cover the Board's administrative start-up costs that are not already identified in the Board's 2007-08 budget.

7. **Increase in state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes and other tobacco products is not specifically exempted or excluded, the excise tax is included in the total amount of the sale and subject to sales or use tax.

This measure would increase the excise tax on cigarettes and result in an other tobacco products tax rate increase, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes and other tobacco products. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed.

8. **Backfill of existing cigarette tax funds.** Under existing law, Health and Safety Code Section 130105 (added by Proposition 10) requires the Board to determine the revenue reductions to any Proposition 99 state health-related education and research programs and the Breast Cancer Fund that are a direct result of the additional taxes imposed by Proposition 10's additional taxes, and annually backfill these amounts from the tax revenues received from Proposition 10.

This measure would not backfill the Cigarette and Tobacco Products Surtax Fund (Proposition 99), California Children and Families Trust Fund (Proposition 10), General Fund, or Breast Cancer Fund.

9. **Distributor discount.** Under existing law, Section 30166 of the Revenue and Taxation Code provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. The discount is intended to help defray the cost (leasing of equipment/labor cost) to the distributor for affixing the stamps.

Currently, distributors receive a discount of \$221.85 per roll of 30,000 cigarette tax stamps $[(30,000 \text{ stamps} \times \$0.87 \text{ tax per package of cigarettes}) \times 0.85 \text{ percent discount} = \$221.85 \text{ discount}]$. By increasing the excise tax on a package of 20 cigarettes to \$1.90, this measure would increase the distributor's discount to \$484.50 per roll $[(30,000 \text{ stamps} \times \$3.47 \text{ tax per package of cigarettes}) \times 0.85 \text{ percent discount} = \$884.85 \text{ discount}]$.

COST ESTIMATE

A detailed cost estimate is pending. However, the Board would likely incur substantial costs related to the administration and collection of the additional cigarette and tobacco products tax proposed by this measure. These costs would be related to notifying taxpayers, developing returns, programming computers, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax.

The proposed tax increase would require enhanced efforts to ensure that the floor stock tax is properly reported and collected, greater compliance efforts for additional billings and delinquencies, and increased investigative staff presence due to increased tax evasion.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Fiscal Year 2007-08

Cigarette Tax. Tax-paid cigarette distributions were about 1,190 million packs in fiscal year 2005-06. The Department of Finance projected a small decline to 1,180 million packs for fiscal year 2006-07. Over the past twenty years, tax paid distributions have averaged a decline of about 3 percent per year. We believe this is a reasonable estimate of the underlying trend for future years, so we project a 3 percent decline for 2007-08. Since the new rate would take effect January 1, 2008, the impacts for fiscal year 2007-08 are about half of the full-year impacts.

Based on previous tax increases and research of experiences in other states, we believe an increase in the tax rate as large as the one proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the split between evasion and consumption is uncertain, we estimate that this bill would cause a decrease of 21 percent in tax paid distributions. This estimate uses a price elasticity of demand of -0.60 calculated by the arc price elasticity formula, applied to an average 2005 price of approximately \$3.95 per pack.²

There is a corresponding floor stock tax, imposed on inventories on January 1, 2008. We assume a three weeks supply of cigarettes would be subject to the floor stock tax, based on a combination of expected sales rates before and after the tax takes effect.

Tobacco Products Tax.³ The Board has set the tobacco products tax rate for fiscal year 2006-07. We assume no change in the rate in fiscal year 2007-08. The proposed \$1.90 per pack increase in the cigarette excise tax rate will not affect the tobacco products tax rate until fiscal year 2008-09.

Fiscal Year 2008-09

Cigarette Tax. Under the current excise tax rate of \$0.87 per pack, we would expect a 3 percent decline in fiscal year 2008-09.

Tobacco Products Tax. Pursuant to Proposition 99, this measure would result in an additional tax on tobacco products at a rate equivalent to the new \$1.90 per pack rate this measure would impose on cigarettes. This tax increase would be effective on July 1, 2008.

² The general price elasticity of demand formula is: $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2) / 2) / (P_1 - P_2) / ((P_1 + P_2) / 2)$, where P = price, and Q = sales.

³ As used here, the term "tobacco products" refers to all tobacco products except cigarettes. Examples of such products include chewing tobacco, snuff, cigars, pipe tobacco, and roll-your-own cigarette tobacco.

The effective tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2006-07 fiscal year is \$0.1465. The current tax rate on cigarettes is \$0.0685 per cigarette.⁴ The tobacco tax rate for 2006-07 is 46.76 percent ($\$0.0685 / \$0.1465 = 0.4676$). Under this measure the tobacco products tax rate would rise from 46.76 percent to 111.60 percent in fiscal year 2008-09. This assumes no change in the average wholesale price of cigarettes for 2006 or 2007.

The wholesale cost (or wholesale sales) of tobacco products was about \$126 million in fiscal year 2005-06. We will assume wholesale costs to stay at approximately this level over the next few years under current law.

Based on previous tax increases, an increase in the tax rate as large as the one proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion. We estimate the decline in sales of tobacco products would be similar to the percentage decline in cigarette sales.⁵

Sales and Use Tax Impacts. We expect that all of the cigarette and tobacco products tax increases are passed on to consumers. For both cigarettes and tobacco products we added sales taxes on the excise tax increases and subtracted sales taxes resulting from projected declines in sales to determine net sales tax gains. Sales taxes are calculated assuming current and projected average retail prices.

Revenue Summary

The revenue impacts of this bill are shown in the table below. The first complete year that all the provisions of the bill are in effect will be fiscal year 2008-09. For fiscal year 2008-09, the General Fund will receive \$1,647.0 million from cigarette sales. However, the other cigarette excise funds will lose a combined total of \$178.1 million, resulting in a net gain of \$1,468.9 million in all cigarette excise taxes. The impacts on tobacco products tax revenues and sales tax revenues are also shown in the table. Proposition 99 tobacco products revenues increase by \$54.1 million. State and local sales and use tax revenues increase by a combined \$63.6 million.

⁴ The current tobacco products tax rate is the equivalent of \$1.37 per pack, \$0.87 per pack for Proposition 99 funds and \$0.50 per pack for Proposition 10 funds.

⁵ Since the \$1.37 per pack tax rate for tobacco products is higher than that of cigarettes (\$0.87 per pack), a \$1.90 per pack tax increase implies a slightly smaller price increase for tobacco products than it does for cigarettes [20 percent for tobacco products compared to 21 percent for cigarettes, both using the arc elasticity of demand formula (the denominator of the formula in footnote 1)].

| Revenue Impacts Summary | | |
|---|----------------------------|------------------|
| | Fiscal Year | |
| | 2007-08 | 2008-09 |
| Cigarette Excise Tax Revenues by Fund (Excludes Floor Stock Tax) | Millions of Dollars | |
| General Fund | \$752.6 | \$1,647.0 |
| Breast Cancer | -\$3.3 | -\$4.6 |
| Proposition 99 | -\$40.7 | -\$57.8 |
| Proposition 10 | -\$81.5 | -\$115.6 |
| Total Cigarette Excise Tax Revenues | \$627.2 | \$1,468.9 |
| Cigarette Floor Stocks Tax | \$112.4 | 0.0 |
| Proposition 99 Tobacco Products Excise Tax Revenue Increase | \$0.0 | \$54.1 |
| Total Net Excise Tax Increase (Cigarettes Plus Tobacco Products Taxes, Includes Cigarette Floor Stock Tax Revenues) | \$739.6 | \$1,523.0 |
| State Sales and Use Tax (at 5.25%) | \$20.6 | \$42.1 |
| Local Sales & Use Tax (at 2.0%) | \$7.9 | \$16.0 |
| District Tax (at 0. 69%) | \$2.7 | \$5.5 |
| TOTALS | \$770.7 | \$1,586.6 |

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